COMMONWEALTH OF VIRGINIA, ex rel.

DAVID W. DESMOND, et al.

v. **CASE NO. PUE970544**

UNITED WATER VIRGINIA, INC.,

Defendant

REPORT OF MICHAEL D. THOMAS, HEARING EXAMINER

September 30, 1998

History of the Case

By notice dated May 22, 1997, United Water Virginia, Inc. ("UWV" or the "Company") notified its customers and the Commission's Division of Energy Regulation (the "Staff") pursuant to the Small Water or Sewer Public Utility Act (§§ 56-265.13:1 through 56-265.13:7 of the Code of Virginia) of its intent to increase its water rates effective July 5, 1997. On June 16, 1997, the Staff received a petition signed by 255 of the Company's customers requesting a hearing on the proposed rate increase.

The Company proposed the following changes to its water rates:

Current Rates

Metered - Single Family Houses	
• Bimonthly for the first 6,000 gallons	$61.32
• Per 1,000 gallons of usage over the first 6,000 gallons	$ 3.13
Metered - Two or More Family Houses	
• Bimonthly charge times the number of families	$61.32
• Per 1,000 gallons of usage over the first 6,000 gallons times the number of families	$ 3.13
Minimum bimonthly service charge	$61.32
Reconnection charge after normal business hours	$40.00

Proposed Rates

Metered - Single Family Houses	
• Bimonthly for the first 5,000 gallons	$67.50
• Per 1,000 gallons of usage over the first 5,000 gallons	$ 4.32

Metered - Two or More Family Houses		
• Bimonthly charge times the number of families		$67.50
• Per 1,000 gallons of usage over the first 5,000 gallons times the number of families	$ 4.32	
Minimum bimonthly service charge		$67.50
Reconnection charge after normal business hours[1]		$80.00

The Company also proposed to change certain portions of its rules and regulations of service.

The Commission entered a Preliminary Order on June 23, 1997, that suspended the Company's proposed rate increase through October 19, 1997, and made the proposed rate increase interim and subject to refund, with interest, effective for service rendered on and after October 20, 1997. In addition, the Commission required UWV to file with the Clerk of the Commission on or before September 30, 1997, certain financial data based on the Company's test year.

The Commission entered an Order of Notice and Hearing on October 6, 1997, that assigned the case to a Hearing Examiner, scheduled a hearing for 10:00 a.m. on March 10, 1998, directed the Staff to investigate the reasonableness of the Company's proposed rate increase, and directed the Company to provide its customers with notice of their right to participate in any hearing before the Commission.

Pursuant to the Commission's aforesaid order, a Notice of Protest was filed with the Commission on November 19, 1997. John J. Healy, William J. McCarty, M.D., Donald W. Desmond, and the following civic and property owners associations: Cabin Point Civic Assn., Glebe Harbor Civic Assn., Stratford Harbor Property Owners Assn., Potomac and Westmoreland Shores Civic Assn., Bay Quarter Shores Civic Assn., Corrotoman Civic Assn., Sherwood Forest Civic Assn., Ebb Tide Beach Civic Assn., Berkley Beach Civic Assn., and Church Point Civic Assn., were listed as Protestants.

The Protestants filed their Protest with the Commission on December 29, 1997. The Protestants voiced several concerns about the Company's rate base. These concerns related to contributions in aid of construction and the acquisition adjustment. They stated these concerns remained unanswered from the Company's previous rate cases. In addition, the Protestants had concerns with the Company's purchase of new information technology equipment, and the fees and expenses charged by the Company's parent holding company. At this time, the Protestants prefiled the direct testimony of John J. Healy and Ronald Schiller.

On January 16, 1998, the Staff moved for an extension of the procedural schedule. In support of its motion, the Staff stated that it needed additional time to evaluate the issues in the case before it could file its testimony that was due on January 30, 1998. In addition, the Staff requested an extension of the filing date for the Company's rebuttal testimony and a continuance of the

[1] The Company's new rules would require the customer to pay the reconnection charge and any outstanding balances in order for service to be restored.

March 10, 1998, hearing date. The other parties to the proceeding did not object to the Staff's request.

The Protestants filed a Motion for Extension of Procedural Schedule on January 21, 1998. In their motion, the Protestants stated that they received new evidence through the Staff's interrogatories to the Company and the Protestants needed additional time to evaluate the evidence and file supplemental direct testimony. The Company objected to the granting of the motion.

By Hearing Examiner's Ruling entered on January 27, 1998, the original hearing date of March 10, 1998, was retained for the purpose of hearing public witnesses, the evidentiary hearing was rescheduled to April 9, 1998, and the procedural schedule for the parties to file direct and rebuttal testimony was adjusted accordingly.

On February 18, 1998, UWV filed a Motion to Strike Portions of Direct Testimony of John H. Healy on Behalf of Protestants. The Company moved to strike all of Mr. Healy's direct testimony relating to the Company's acquisition adjustment and the establishment of the Company's rate base. The Company argued the Commission previously decided these issues in UWV's 1989 rate case. *Application of Virginia Suburban Water Co.*, Case No. PUE890082, 1991 S.C.C. Ann. Rep. 267. The Company further argued that Commission policy precludes relitigation of issues that have been previously decided by the Commission.

The Protestants filed a Response of Protestants to Motion to Strike Portions of Prefiled Testimony of John J. Healy on February 26, 1998. In their Response, Protestants argued that past legislative action by the Commission in determining fair and reasonable water rates does not act as a bar in future legislative proceedings to considering all of the components that comprise the final rate. The Protestants further argued the acquisition adjustment approved in the 1989 rate case is contrary to the holding in *Princess Anne Utilities Corp. v. Commonwealth of Virginia,* 211 Va. 620 (1971), for the reason that a water company is not allowed to earn a return on utility plant contributed by lot owners and developers.

On March 3, 1998, UWV filed a Motion for Permission to File Reply and a Reply to Response of Protestants to Motion to Strike Portions of Direct Testimony of John J. Healy on Behalf of Protestants. In its Reply, UWV argued that consistent with the policy announced by the Commission in *Application of Lake Monticello Service Co.,* Case No. PST840002, 1986 S.C.C. Ann. Rep. 148, it is "appropriate" in this case to strike portions of Mr. Healy's testimony to avoid the regulatory burdens that will be imposed by Mr. Healy and the Protestants' relitigation of an issue that was considered and decided by the Commission.

By Hearing Examiner's Ruling entered on March 4, 1998, the Motion to Strike was found to be premature and was taken under advisement until such time as the motion was renewed at the scheduled evidentiary hearing.

On March 10, 1998, a hearing was convened in order to receive the comments of public witnesses. The Company and the Staff appeared by their respective counsel. Ten customers of UWV appeared as public witnesses and testified in opposition to the proposed rate increase.

On March 19, 1998, UWV filed a Motion to Strike the revised prefiled testimony of Staff witness Amy J. Gilmour filed on March 18, 1998. In her revised testimony, Ms. Gilmour excluded any Company rate case expenses from her revenue calculations. The Company argued that it had been prejudiced by the Staff's action since it reduced the amount of time available to the Company to respond to issues raised in the testimony. In its response, the Staff argued that Rule 6:2 of the Commission's Rules of Practice and Procedure permits a "party" to correct or supplement its prefiled testimony and exhibits before or during the hearing for good cause and with leave of the Commission. Although the Staff is not a "party" to any proceeding before the Commission, the Staff argued that, implicit in the Commission's Rules, is the opportunity to correct or supplement its prefiled testimony.

By Hearing Examiner's Ruling entered on March 24, 1998, the Motion to Strike was denied and UWV was afforded additional time to file rebuttal testimony to the issues raised in the Staff's revised testimony.

The evidentiary hearing was convened on April 9, 1998. Two additional public witnesses appeared and testified, Mr. Norm Risavi, the county administrator for Westmoreland County, and Mr. W.W. "Woody" Hynson, a member of the Westmoreland County Board of Supervisors. The Company appeared by its counsel, Donald G. Owens, Esquire and Walton Hill, Esquire, and offered the testimony of three witnesses: Ms. Joyce Creel, the Company's local manager; Mr. Gary Prettyman, the Company's accounting witness; and Ms. Pauline Ahern, the Company's cost of capital witness. The Staff appeared by its counsel, Marta B. Curtis, Esquire and William H. Chambliss, Esquire, and offered the testimony of three witnesses: Ms. Amy Gilmour, the Staff's accounting witness; Ms. Mary Owens, the Staff's cost of capital witness; and Mr. John Stevens, the Staff's tariff and rate design witness. The Protestants appeared by their counsel Joseph E. Blackburn, Esquire; however, they did not sponsor any witnesses. A transcript of the hearing is filed with this Report.

Subsequent to the hearing, counsel for UWV filed an affidavit prepared by Ms. Ahern. During her cross-examination, a question was raised regarding the difference in the amount of long-term debt of United Waterworks, Inc. shown in one of the schedules to Ms. Ahern's testimony, and the amount of long-term debt for United Waterworks shown in one of the annual reports for United Water Resources, Inc. Apparently, the difference related to the manner in which United Waterworks finances and records its tax-exempt long-term debt. The Protestants objected to the affidavit coming into evidence after the record was closed. By Hearing Examiner's Ruling entered on June 3, 1998, the Protestants' motion to reject the proffered affidavit was granted.

The Company, the Staff and the Protestants filed post-hearing briefs.

Summary of the Record

The public witnesses, who appeared and testified on March 10, 1998, raised a number of issues for the Commission's consideration in this case. A large number of the Company's customers

are on fixed incomes and are generally opposed to any type of a rate increase for the Company. (Tr. at 50-51). The high rates are not only affecting those on fixed incomes but also those young families who are trying to make ends meet. (Tr. at 12). They cite the failure of the Company to make promised major capital improvements and the already high rates they pay for water service as reasons to disapprove the requested increase. (Tr. at 18-19, 29). By way of comparison, they cite the rates charged by other municipalities and small water companies. For example, the testimony indicated that the Town of Colonial Beach's water rate is $35.25 per quarter for unlimited family use, and King George County's bimonthly water rate is $31.20 for 8,000 gallons and $2.65 for each additional 1,000 gallons. They also compared a United Water bill to one from Sydnor Hydrodynamics, Inc. The United Water bill was $97.74 for 12,000 gallons and the Sydnor bill was $46.43 for 12,300 gallons. (Tr. at 11-12, 51-52). The public witnesses understand that the Commission does not consider the rates charged by other utilities in setting the rates for a particular utility. However, they argue that the Commission should not ignore market comparisons when looking at the overall reasonableness of a company's rates. (Tr. at 36-38).

The public witnesses also testified in opposition to the decrease in the minimum monthly usage from 6,000 gallons to 5,000 gallons. (Tr. at 10, 36). They testified that the Company's water conservation justification is unfounded. In their opinion, the lower minimum monthly usage will result in increased revenue for the Company. They testified that water conservation is not an issue in their area. (Tr. at 45-46). They also provided testimony that a family of four living in a three-bedroom house in Westmoreland County uses 7,000 to 10,000 gallons of water per month. They also cited a Virginia Department of Health regulation that calculates average water consumption at 75 gallons per day per person for basic sewage needs. (Tr. at 43). For the same family of four, this produces an average water consumption of 9,000 gallons per month. This total does not include other incidental water uses such watering lawns or gardens. (*Id.*).

The public witnesses also expressed some concern about the Company's operating expenses. They could not understand why it sometimes takes two men to read water meters. (Tr. at 14). Since most of the Company's customers currently read their own electric meters on a bimonthly basis for Northern Neck Electric Cooperative, they argued that they could read their own water meters and pass those cost savings on to the Company. (Tr. at 46-47).

On April 9, 1998, two additional public witnesses appeared and testified in opposition to the proposed rate increase. Mr. Norm Risavi, the county administrator for Westmoreland County, testified that his office received more calls over this rate increase than any other issue he has faced in his five years as county administrator. (Tr. at 59). He was particularly concerned when a number of those citizens who called inquired about the County taking over a private water system and running it more efficiently. (*Id.*). He provided additional water rate comparisons from surrounding communities. These included the Town of Tappahannock's bimonthly rate of $13.00 for 5,000 gallons; the Town of Warsaw's bimonthly rate of $34.60 for 6,000 gallons; the Town of Montross's bimonthly rate of $22.00 (in town) and $33.00 (out of town) for 12,000 gallons; and the Town of Bowling Green's bimonthly rate of $22.00 (in town) and $44.00 (out of town) for 5,000 gallons. (Tr. at 60-61). Mr. Risavi confirmed that none of these jurisdictions subsidized their water systems through general fund revenues; they relied entirely on user fees for operating their water systems. Mr. Risavi recognized that some of these municipal systems might have received low interest loans or

partial grant funding to construct the system; however, he was still disturbed by the significant difference in cost between UWV and the municipal systems. (*Id*.). Mr. Risavi encouraged the Commission to examine whether the customers of UWV are subsidizing less profitable operations of its parent. (Tr. at 62).

Mr. W.W. "Woody" Hynson, a member of the Westmoreland County Board of Supervisors, was the final public witness. He testified that UWV's rate increases have far exceeded the rate of inflation. Based on his review, it appears that the average water bill in the Commonwealth of Virginia is about $35.00 a month. In his opinion, UWV's water rates are about double what they should be. (Tr. at 65-66).

Ms. Joyce L. Creel, the Company's local manager, was the first witness to testify on behalf of the Company. Ms. Creel is responsible for overseeing the day-to-day operation and maintenance of the Company's water systems. The Company and its successors have employed her in various capacities since 1984. Ms. Creel testified that she has spent approximately 645 hours of her time on the Company's rate case. None of this time was included as part of Company's rate case expense. (Ex. JLC-1, at 1-2; JLC-3; Tr. at 109-112).

Ms. Creel provided a brief history of the Company and an overview of the Company's operations. In 1973, Suburban Water Supply Company ("Suburban") was incorporated and operated water systems in the City of Petersburg, Prince George County, Surry County, James City County, Hanover County, and Westmoreland County. During the mid-1980's Suburban provided poor customer service and failed to comply with state regulations. Suburban did not have the resources to comply with regulations promulgated by the Virginia Department of Health. In 1987, General Waterworks Corporation ("General Waterworks") purchased Suburban. When General Waterworks purchased Suburban the Company was considered to be a troubled water company by the Virginia Department of Health and the State Corporation Commission. General Waterworks renamed the Company, Virginia Suburban Water Company ("Virginia Suburban"). In 1994, United Water Resources, Inc. ("UWR") merged with General Waterworks. A subsidiary of UWR, United Water Management and Service Company ("UWMSC"), assumed the contractual obligation to provide financing, accounting, legal, engineering, human resources, and other operational support functions, which had formerly been provided by General Waterworks, to Virginia Suburban. In 1995, Virginia Suburban was renamed United Water Virginia. (Ex. JLC-1, at 3; Tr. at 79, 82-83).

The Company has eight full-time employees: a local manager, a customer service representative, an accounting clerk, a supervisor, and four utility technicians. At December 31, 1996, the Company was serving 1,916 metered residential customers in 21 subdivisions located in King William, Essex, Lancaster, Northumberland, and Westmoreland Counties. The Company's customer base is seasonal and at December 31, 1996, it had 1,815 active customers. Since 1989, about 25 customers have been added to the various systems. There are 17 groundwater systems serving these subdivisions. The water is drawn from 31 deep wells each with a pump house, pumps and storage tanks. The full system route is almost 300 miles. In 1996, the Company pumped approximately 85 million gallons of water and sold approximately 73 million gallons of water. The difference represents approximately 600,000 gallons used to flush the systems' tanks and 11.4 million gallons in unaccounted for water. Each of the systems operates automatically depending on system demand.

The systems treat the water at the well to ensure compliance with Virginia Department of Health regulations. The Company's vehicles are leased and are used to perform routine maintenance, answer service calls, and collect water samples for testing. (Ex. JLC-1, at 5; Tr. at 78-79, 83-84 and 115-17).

Since 1987, the Company has spent in excess of $1.6 million on improvements to the various water systems. These expenditures included installing new meters, wells, pumps, motors, hydropneumatic tanks, storage tanks, pressure relief valves, and chlorine injection pumps. The major capital expenditure included in the present filing is the construction of a new well, pump house, and associated tanks and piping at a projected cost of $132,700. The Company has projected that it will spend a total of $246,000 on additional capital improvements. Ms. Creel testified that the capital improvements in the Company's water systems have benefited the Company's customers and have enabled the Company to comply with increasingly stringent regulatory requirements. Ms. Creel further testified that, despite the large number of customer complaints about the Company in the present proceeding, she believed that they had no service-related complaints. (Ex. JLC-1, at 4 and 6-7; JLC-2, Exhibit No. 2; Tr. at 95).

The Company's second witness, Mr. Gary Prettyman, testified on all of the accounting issues for the Company and the Company's proposed tariff. In its application, the Company is requesting an increase in operating revenues of $128,375, which equates to a 16.06% increase in revenues. The Company last increased its rates on March 9, 1992, when it placed the rates proposed in Case No. PUE920015 into effect on an interim basis. The proposed rate increase represents an annual 3% increase in rates since the Company's last rate increase. The Company is requesting an overall rate of return of 9.99%, with a return on equity of 11.90%. The Company also proposed a change in rate design to address the concerns of its seasonal customers. The Company is proposing to reduce the minimum bimonthly allowance from 6,000 gallons to 5,000 gallons. The Company's test year data indicates that 52% of its customers use 5,000 gallons or less water. Under the proposed rate design, these customers would see their water rates increase 10.08%. For customers using the old allowance of 6,000 gallons, their rates would increase 17.12%. Those who use 7,000 gallons would see their rates increase 18.14%. In addition, the Company has proposed an $80 after-hours reconnection fee. (Ex. GSP-4, at 2, 22-23).

Mr. Prettyman testified that the major components driving the proposed rate increase are related to plant additions, depreciation related to those additions, salaries and wages, other post-employment retirement benefits ("OPEBs"), tank painting, leased vehicle expense**,** outside services, and the Company's new Integrated Financial Management System ("IFMS"). (Tr. at 125).

With respect to the accounting differences between the Company and the Staff, Mr. Prettyman testified that there were about 28 accounting issues where he could agree with the Staff. He also testified there were about 15 where he could not agree. The majority of the differences between the Company's and the Staff's position relate to six accounting issues. These are the proper accounting treatment for OPEBs, IFMS, outside services, rate case expense, revenues, and rate base. Mr. Prettyman testified that if he used all of his recommendations and the Staff's recommended 35% tax rate and 9.132% overall rate of return this would produce an increase in operating revenues of approximately $125,000. Furthermore, if he used all of his recommendations and the Company's

9.99% overall rate of return this would produce an increase in operating revenues of approximately $150,000. (Tr. at 131-32).

With respect to the rate design issues, Mr. Prettyman had concerns with two of the Staff's proposed recommendations. The first involved the Staff's introduction of a third rate block of $6.00/1,000 gallons for usage over 15,000 gallons. Mr. Prettyman testified that the introduction of this block might cause revenue volatility. As customers seek to conserve water, the Company might not recover the full level of revenues authorized by the Commission. In addition, Mr. Prettyman opposed changing the connection fee language in the Company's tariff from the present $610, which includes any applicable taxes, to $550 plus any applicable federal taxes. Mr. Prettyman believes the Staff's proposal would cause confusion for the Company's customers. (Ex. GSP-5, at 33-34; Tr. at 131-32).

The Company's final witness was Ms. Pauline Ahern, the Company's cost of capital witness. In her testimony, Ms. Ahern recommended an overall rate of return for UWV of 9.99%. That recommendation was based on the consolidated capital structure of United Waterworks (UWV's parent company) and its subsidiaries at December 31, 1996, which consisted of 52.50% long-term debt at a cost rate of 8.29%, 0.15% preferred stock at a cost rate of 5%, and 47.35% common equity at a cost rate of 11.90%. Ms. Ahern's recommended return on equity of 11.90% was based upon the application of the Discounted Cash Flow Model, the Risk Premium Model, and the Capital Asset Pricing Model for five water companies of similar risk to UWV. Ms. Ahern checked the reasonableness of her recommendation by using a pretax interest coverage test and comparable earnings analysis. (Tr. at 184).

The Staff's first witness, Ms. Amy Gilmour, testified on the accounting issues in the case for the Staff. After making two corrections to her prefiled testimony, she recommended an additional revenue requirement for UWV of $28,322 based on the Staff's recommended return on equity of 10.10%. Ms. Gilmour confirmed that a number of accounting issues remained in dispute between the Staff and the Company. These included increased revenues due to customer growth, proforma payroll expense, Statement of Financial Accounting Standards ("SFAS") 106 costs, actuarial study costs, IMFS costs, rate case expenses, updated rate base and related adjustments, the appropriate federal tax rate, and parent company debt adjustment. She further recommended that the Company should not continue to collect the tax gross-up on connection fees. Her recommendation was based on a change to Section 118(B) of the Internal Revenue Code. This change removed language that previously excluded connection fees from the definition of contributions in aid of construction ("CIAC"). In addition, Ms. Gilmour testified that it was the Staff's position that the Company's rate case expenses were excessive and the Staff revised its revenue requirement to remove the expense in its entirety. (Tr. at 232-33).

The Staff's second witness, Ms. Mary Owens, addressed the appropriate capital structure, cost of equity, and overall cost of capital for UWV. Ms. Owens used a Discounted Cash Flow ("DCF") analysis for United Water Resources (UWV's ultimate parent) and a group of five water companies to arrive at her recommended range of 9.60% to 10.60% for UWV's cost of equity. In addition, she performed two risk premium analyses to supplement her DCF results, a Capital Asset Pricing Model and an Ex Ante Risk Premium methodology. In order to arrive at a total cost of

capital, Ms. Owens updated the United Waterworks (UWV's parent company) capital structure as of December 31, 1997. Based on the updated capital structure and her recommended cost of equity range, she calculated a range of 8.875% to 9.390% for UWV's total cost of capital. (Ex. MEO-30, at 17-19; Tr. at 300-01).

In her testimony, Ms. Owens made four recommendations specifically related to the Company's cost of equity and capital structure proposals. First, she recommended using a cost of equity range of 9.60% to 10.60%, with rates set at the 10.10% midpoint, based on market data through January 1997, rather than the 11.90% return on equity proposed by the Company. Second, she recommended using an updated December 31, 1997, capital structure for United Waterworks, rather than the end of test period December 31, 1996, capital structure proposed by the Company. Third, she recommended including investment tax credits in the ratemaking capital structure. Finally, she recommended that long-term debt balances in the capital structure be reflected net of unamortized debt issuance expenses. (Ex. MEO-30, at 2; Tr. at 301).

Ms. Owens also made two general recommendations concerning future rate filings by the Company. First, she recommended that in any future rate application, the Commission require UWV to file any financial data the Staff deems necessary with respect to cost of equity, cost of capital, or capital structure issues. The types of data the Staff would require include Company profitability data, capital market data, cash flow and interest coverage ratios, capital structure per balance sheet and capital structure for ratemaking purposes, comparative balance sheets, income statements, and changes in financial position, Stockholders' Annual Reports, and SEC 10-Q or 10-K Reports. Second, she recommended that the Commission require the Company to file any future capital structure and cost of capital statements in accordance with the methodology adopted by the Commission in the Company's most recent rate case where these issues were addressed. (Ex. MEO-30, at 2-3; Tr. at 301-03).

Finally, Ms. Owens commented that she believed the data used in Ms. Ahern's testimony was out-of-date. In her opinion, market conditions had changed significantly since Ms. Ahern prepared and filed her testimony. By way of example, Ms. Owens cited the drop in yield of the 30-year Treasury bond from the 6.90% used by Ms. Ahern in her testimony to the 5.97% used by Ms. Owens. Consequently, Ms. Owens believed that Ms. Ahern's analysis and final recommendation were not reflective of current market conditions. (Ex. MEO-30, at 21-22; Tr. at 303).

The Staff's final witness was Mr. John Stevens. Mr. Stevens's testimony covered the proposed changes in the Company's tariff and rate design. Mr. Stevens adopted the prefiled testimony of Kimberly N. Greenwood, a former employee of the Commission's Division of Energy Regulation. Mr. Stevens testified that the Staff supported the reduction in the bimonthly minimum usage from 6,000 to 5,000 gallons. Mr. Stevens recommended a reduction in the monthly minimum service charge from $67.50 to $66.50. In addition, he recommended the usage rate for 5,000 to 15,000 gallons be reduced from $4.32 to $4.00 per 1,000 gallons. In an effort to discourage wasteful usage, he further recommended the creation of a third rate block for usage above 15,000 gallons. His recommended rate for this usage block was $6.00 per 1,000 gallons. Mr. Stevens also proposed a seasonal charge of $10.00 per month to allow for a more equitable distribution of fixed costs among the Company's full-time and seasonal customers. Finally, Mr. Stevens recommended that should the

Commission approve a revenue requirement that is less than that proposed by the Company, the reduction should be applied to the Company's minimum charge. (Ex. JAS-32, at 4-6; Tr. at 311).

Mr. Stevens also recommended the following changes to the Company's miscellaneous service charges and tariff: (1) adopt an $80.00 after-hours reconnect charge; (2) delete Rule No. 10(B) regarding landlord/tenant responsibility for water bills from the Company's tariff; (3) delete "or his agent" from Rule No. 16(E); (4) reduce the Service Connection Charge to $550 and add language allowing for a gross-up of any applicable taxes; (5) modify Rule No. 8 to allow 10 days' written notice before service is disconnected for specified reasons; and (6) modify Rule No. 11 to state that water bills are due within 30 days of the billing date and that, after such time, the Company can disconnect service after 10 days' written notice. (Ex. JAS-32, at 12; Tr. at 311-12).

Although the Protestants prefiled testimony of two witnesses in this case, they did not sponsor that testimony into the record. Instead, they developed their case through extensive cross-examination of Company and the Staff witnesses. (Tr. at 75 and 336).

Discussion

This case was brought pursuant to the Small Water or Sewer Public Utility Act, §§ 56-265.13:1 through 56-265.13:7 of the Code of Virginia. Section 56-265.13:4 of the Code of Virginia provides the standard for reviewing small water company rate cases. This statute provides, in part, that:

> The charges made by any small water or sewer utility for any service rendered shall be (i) uniform as to all persons or corporations using such service under like conditions and (ii) nondiscriminatory, reasonable and just. Every charge for service found to be otherwise shall be unlawful. Reasonable and just charges for service within the meaning of this section shall be the lowest charges as shall produce sufficient revenues to pay all lawful and necessary expenses . . . . (Emphasis added).

Although the Commission does not consider the rates charged by other utilities when setting rates for a utility, as pointed out by the Intervenors, such comparisons may be important in determining whether a particular utility's rates should be more closely scrutinized. In this case, the rate proposed by the Company is almost double the rate charged by any other water company operating within a 50-mile radius of UWV. Granted, UWV was compared to some municipal water systems and UWV faces some unique challenges in operating a water system over a large geographical area, these items alone do not account for the large disparity in the rates UWV charges its customers.

Based on the standards set forth above and the record herein, I find the rates proposed by the Company are excessive. I recommend the following adjustments be made to the Company's proposed rates to produce just and reasonable rates.

I. Accounting Issues

The Staff made approximately 40 accounting adjustments to the rates that were filed by the Company. The Company has agreed with a number of those adjustments. These include: group insurance, 401K, payroll expense, electric power, chemicals, tank painting, management service charges, copier lease, leased vehicles, other operations and maintenance ("O&M") expense, depreciation, amortization of utility plant acquisition adjustment, property and special taxes, payroll taxes, and other. These adjustments appear reasonable and I recommend the Commission accept these adjustments to the Company's rates. The following issues, however, remain in dispute: revenues, salaries and wages, pension benefit, other postretirement benefits (SFAS 106), rate case expense, insurance other than group, outside services-computer, internal audit, uncollectibles, gross receipts taxes, parent company debt adjustment, deferred federal income taxes, and rate base.

Revenues

This issue has two subparts. The first involves customer growth and the second involves average water use per customer.

With respect to customer growth, the Company and the Staff agree that the average number of customers for the 1996 test year was 1,878 and that this number should be adjusted to reflect customer growth to calculate current revenues. The parties disagree on the method to account for customer growth. In its prefiled direct testimony, the Company calculated customer growth as of June 30, 1997, by looking at the actual number of services added in the last three years, which on average was 20, and added 20 customers to the 1996 test year average. (Ex. GSP-4, at 5-6). The Staff used a different methodology to calculate a growth of 30 customers as of September 30, 1997. The Staff calculated customer growth by starting with the actual number of customers as of September 30, 1997. That time period corresponds to its rate base update. The Staff's methodology compared the number of customers at September 30, 1996, to the number of customers at September 30, 1997. The Staff believes this takes into account the Company's seasonal customer base. The difference in the total number of customers was 31. The Staff then made an adjustment to eliminate any double up in customers that were already reflected in the test year average for October, November and December 1996. The Staff compared the number of customers for these three months with the number of customers for the same period the previous year and arrived at a possible double up of 1, which they subtracted from 31 to arrive at their number for customer growth. (Ex. AJG-24, at 3-5).

In its rebuttal testimony, the Company proposed an alternative methodology that it argued was superior to the Staff's methodology in accounting for the Company's seasonal customer base. The Company argued that the Staff's methodology of looking at customer growth at a given point in time was inappropriate. The Company's new methodology calculated the average customer growth for the twelve months ending September 30, 1997. This resulted in a number of 12 as the customer growth for the period. (Ex. GSP-5, at 13-14).

I find that both the Company's and the Staff's methodologies suffer from inherent flaws. The Company's new methodology tends to understate customer growth as of September 30, 1997, and,

the Staff's retrospective adjustment to account for the double up understates the amount of the double up and consequently overstates the amount of customer growth. Conceptually, I find that the Staff's methodology reasonably accounts for the Company's seasonal customer base. However, the adjustment that is made to account for any double up of customer growth should be made prospectively. This adjustment may be calculated by dividing 31 (the difference between the number of customers at September 30, 1996, and September 30, 1997) by 12 (number of months in the period) to find the average number of customers added per month. This results in a number of 2.58, which should be rounded up to 3. The result should then be multiplied by 3 (number of months in the double up period), which results in a possible double up of 9 customers for the period October, November and December 1996. This number should then be subtracted from 31 to obtain a customer growth of 22 at September 30, 1997. Taking into consideration the Company's initial proposal of 20 for customer growth as of June 30, 1997, customer growth of 22 as of September 30, 1997 appears to be reasonable.

The second subpart of this issue involves average water use per customer. The Staff used test year consumption, before billing adjustments, divided by the average number of customers for the test year to calculate average water usage per customer of 38.94 thousand gallons. (Ex. AJG-24, at 4-5). The Company agreed with the Staff's use of the 12-month average use per customer during the test year; however, the Company believes it is more appropriate to do the calculation based upon net consumption, which includes billing adjustments. The Company's methodology resulted in an average water use per customer of 38.33 thousand gallons. The Company believes its methodology properly reflects consumption during the test year and allows for better matching of the revenues billed and booked. (Ex. GSP-5, at 12-13).

Apparently, the Staff requested information from the Company on the billing adjustments and was unable to get a satisfactory response from the Company. For this reason, the Staff based its calculation on gross sales without billing adjustments. (Tr. at 236). On surrebuttal, the Company's accounting witness testified that the billing adjustments in question were such things as initial bills, final bills, rereads, and leak adjustments. (Tr. at 338). With the Company's explanation of the billing adjustments, I find the Company's methodology for calculating average water usage per customer to be reasonable, since it more accurately reflects revenue earned by the Company.

Salaries and wages

The issue of salaries and wages primarily relates to the methodologies used by the Staff to calculate the Company's expenses for overtime and summer help. The Company has a philosophical disagreement with the Staff's use of a three-year average for calculating overtime expense and then not using a three-year average for calculating summer help expense. The Company's accounting witness testified that he was unaware the Commission used three-year averages in a rate case based on test year data. The Company believes that if averages are to be used they should be used in all areas where appropriate. The Company's accounting witness testified that both the overtime and summer help hours fluctuate from year to year. (Ex. GSP-5, at 17). The Staff's accounting witness testified that she used a three-year average of overtime expenses to address an anomaly in the data. Apparently, because one employee moved from non-exempt to exempt, it was necessary to compute the overtime hours excluding this employee's overtime hours.

The Staff's witness was not aware of any anomalies in the summer help data to warrant a change in methodology. (Ex. AJG-24, at 6; Tr. at 236-237).

I find that the use of a three-year average to calculate summer help hours is reasonable. If a methodology is selected to calculate a component of a rate, that methodology should be used consistently throughout the calculation. I also agree with the Company that if a three-year average is used to calculate overtime expense because of an anomaly in the data, the anomaly should not be removed before the average is calculated. I agree with the Company that this has the effect of understating the Company's going-forward overtime expense.

An issue related to salaries and wages is an accrual for payroll expense the Staff included in its 1996 per books payroll expense of $231,513 in Staff adjustment No. 2. (Ex. AJG-24 at Appendix pg. 3). The per books payroll expense the Staff used includes an accrual that was booked to 1996 payroll expense in order to state payroll expense on a full accrual basis. The Staff believes that, since it calculated a fully-annualized level of salary expense, it is proper to compare the pro forma level to the accrued test year amount. The Staff believes that using the actual payroll expense, as advocated by the Company, overstates the pro forma payroll expense by the level of the test year accrual. (Ex. GSP-5, at 18-19; Tr. at 237). I agree with the Staff that all payroll expense accrued in the test year should be included in the Company's 1996 per books payroll expense.

Pension Benefit Study

Another contested issue involves the cost of a pension benefit actuarial study specifically prepared by the Company for this rate case and whether this cost should be included in the Company's rates. The Staff disallowed the cost of the actuarial study on the basis that it was not necessary and it was not a recurring expense. The Staff's accounting witness testified that the Company currently books its pension costs based on an annual system-wide actuarial study. She further testified that the Staff does not require multi-jurisdictional companies to prepare a jurisdictional actuarial report for a rate case, nor did the Staff request one in this case. She testified that the Staff would accept the system-wide report for adjustment purposes. (Ex. AJG-24, at 10; Tr. 237-238).

The Company's accounting witness testified that, based on the Company's experience in prior rate cases and the Staff's preaudit request, the Company thought it was appropriate to have a Virginia-specific actuarial study performed in anticipation of this rate case and include the cost of the study for pro forma purposes. The Staff's preaudit request asked the Company to "[p]rovide copies of the actuarial reports that provide the basis of pension and OPEB costs for the test year and pro forma year." (Ex. GSP-5, at 19-20 and Schedule 3; Tr. at 178).

The resolution of this issue turns on whether the Company reasonably incurred the cost for the Virginia-specific actuarial study. I find that the cost of the actuarial study was not reasonably incurred by the Company and should not be included in the Company's rates. The Company currently has a management and service contract in place with UWMSC to provide financing, accounting, legal, engineering, human resources, and other operational support functions. One of the reasons to have such a contract in place is to gain economies of scale among a number of operating

companies with respect to certain administrative requirements, one of those being calculation of pension benefits for the various operating companies' employees. In this case, the Virginia-specific actuarial study was completely unnecessary when the Company's pension liability should have already been determined in the annual system-wide actuarial study.

Other postretirement benefits (SFAS 106)

There are two subparts to this issue. The first is the proper amount of SFAS 106 costs that the Company should be able to recover in rates, and the second is the proper amount of the unfunded other post-employment retirement benefit ("OPEB") liability to be deducted from the Company's rate base. The resolution of this issue turns on the interpretation of the Commission's OPEB Rules adopted in Case No. PUE920003, 1992 S.C.C. Ann. Rep. 315.

The Commission's OPEB Rules provide, in part, that:

> (3) Recovery of OPEB cost accruals in rates shall not be permitted unless such accruals are fully funded. Any unfunded OPEB liability shall be deducted from rate base unless deferred for regulatory purposes.
>
> . . . .
>
> (6) Differences in implementation of accrual accounting for expenses for reporting and ratemaking purposes may be deferred only if (a) the company is earning below its authorized range of return on equity and will file for a change in rates within two years of implementing SFAS 106 or two years from the date of this order, whichever is later and (b) the deferral is recognized in the transition obligation, amortized beginning with the effective date of the change in rates.

The Staff argues that the Company missed its opportunity to include the deferred SFAS 106 costs in rates. The Company implemented SFAS 106 on January 1, 1995. Pursuant to the Commission's OPEB Rules, the Company had until January 1, 1997, to file a rate case and include the deferred SFAS 106 costs in rates. This rate case was filed on May 22, 1997, more than four months after the deadline in the Commission's Rules. The Staff further argues that, had the Company met the filing deadline, it still has not complied with the Commission's Rules by demonstrating that it was earning below its authorized rate of return on equity. Finally, the Staff argues that the Company should not be permitted to include its current SFAS 106 accrual costs in rates because it has only funded the tax advantaged amount, which is significantly less than the total accrual. (Ex. AJG-24, at 7-9; Tr. at 238-40).

The Company argues that this is its first rate case since it implemented SFAS 106 and that, with the exception of the filing date of the rate case, the Company's filing with respect to SFAS 106 costs is consistent with the Commission's Rules. In its Application, the Company has requested full accrual as an operating expense; modified the transition amortization from 20 to 40 years; requested deferral and recovery of the cumulative amount deferred from April 1, 1994 through December 31, 1997; and amortized that deferred amount over 15 years. Finally, the Company argues that the Staff's position is unduly harsh on the Company for a technical mistake. (Ex. GSP-5, at 20-22; Tr. 127-28 and 340-41).

I agree with the Staff's position on this issue. The Commission's OPEB Rules are clear and unambiguous. The service list attached to the Commission's Final Order adopting the OPEB Rules

indicates that the Company received a copy of the Rules when they were adopted. The Company, therefore, has no excuse for failing to know their contents, specifically the requirements that accruals be fully funded and the deferred accrual filing deadlines. There is nothing that would have prevented the Company, prior to the deadline in the Commission's Rules, from filing an application for an extension of time with the Commission. The Commission routinely grants requests for additional time in other matters for good cause shown. Consequently, the Commission should not permit the Company to recover its deferred SFAS 106 costs in rates. The Commission should direct the Company to include only the funded portion of its SFAS 106 costs in rates. In addition, the Commission should further direct the Company to deduct the unfunded portion of its SFAS 106 costs from rate base.

Rate case expense

The rate case expense was the most divisive issue in this case. At times, it appeared as if this case were a general rate case for a major utility, rather than a request for a rate increase involving a small water company serving 1,878 customers in rural Virginia. In large part, the litigious attitude of the parties was responsible for the rate case expense being larger than what it otherwise should have been.

In the Staff's initial prefiled direct testimony, the Staff's accounting witness accepted the Company's estimate for rate case expense less the cost of a depreciation study. In that written testimony, the Staff witness, however, commented that the Company could have spent less on rate case expense had the Company utilized personnel from UWMSC to prepare the case, rather than outside consultants. She testified that she worked primarily with personnel from UWMSC when she conducted her audit of the Company's books and she believed they were capable of preparing a rate case. She further testified that the Company's estimated rate case expense was 136% of the Company's adjusted operating income and over 85% of the revenue increase requested in this case. She advised the Company that its limited resources would not support a large rate case expense. She further advised the Company that the Staff was not proposing an adjustment to rate case expense in this proceeding, although it may do so in the future if the Company continued to incur excessive expenses. (Ex. AJG-24, at 12-13).

Ten days after its direct testimony was filed, the Staff revised the rate case expense testimony of its accounting witness. In support of the revision, Staff witness stated she believed her original testimony sent the wrong signal to the Company and the Commission. She further stated that the Staff no longer supported the rate case expense proposed by the Company. She revised her schedules and revenue requirement to exclude the expense. Apparently, the Staff wanted to place the burden of proving the reasonableness of the rate case expense on the Company. The Staff believed the Company had not met its burden of proof on the level of rate case expense to be recovered in the cost of service. (Ex. AJG-25, at 1-2).

As discussed earlier in this Report, the Staff's revised testimony precipitated the filing of additional pleadings by the Company. The Company was permitted the opportunity to file supplemental rebuttal testimony to address rate case expense.

The Company's supplemental rebuttal testimony covered five substantive areas. First, the Company's accounting witness testified that only $1,755 of the Staff's $5,436 adjustment for the depreciation study was included in the Company's rate case expense. Second, he testified that the Staff's assumption that the case could have been prepared at less cost by personnel of UWMSC was based solely on the hourly rate charged by the consultants and ignored the time required to prepare a case and the fact the consultants' fees were capped. Third, he testified that the Company's decision to use outside consultants was prompted by concern raised in the Commission's final order in the Company's last rate case. Apparently, the Commission disallowed a large portion of the Company's rate case expense because the Commission found that the Company had no incentive to control costs if affiliated personnel were used to prepare the rate case. Fourth, he testified that the Company had sought to control costs by capping the fees of outside consultants and attorneys, however the cost of this proceeding had already exceeded the caps. Finally, he quantified the time and expense involved in responding to interrogatories and other matters raised in the litigation. (Ex. GSP-6, at 3-17).

At the hearing, the Staff's accounting witness testified the Staff believed the use of consultants added to rather than decreased the rate case expense. She testified that she had to work through two layers, the in-house personnel and the outside consultants and this added to the cost. In addition, she testified the reason so many questions were propounded to the Company was the Company's responses lacked detail, raised new questions, or failed to answer the questions. Finally, she testified that, as a Class C water company, UWV does not have to file the supporting documentation for its rate case that larger companies are required to file, therefore, the Staff had to request this information. On cross-examination, she admitted that it was reasonable for the Company to respond to data requests, file direct testimony, analyze the positions of other parties and take issue with those positions on which the Company did not agree. (Tr. at 259-60).

At the hearing, the Company's accounting witness testified that the Company was relying on its prefiled supplemental rebuttal testimony to support its rate case expense. On cross-examination by the Staff, the Company's accounting witness testified that the Company was seeking $111,255 in rate case expense. He testified that this included $48,500 for his and the cost of capital witness's time; $1,755 for the depreciation study expense; $10,000 for work performed by UWMSC; $1,000 for miscellaneous expenses; and $50,000 estimated for attorney fees. He further testified that rate case expenses could approach $200,000, if fees could be paid above the cap. He testified that his firm's fee had been capped at $48,500. He further testified that he had reached his cap and his hourly fee of $150 per hour had effectively dropped to $95 per hour and was continuing to drop. (Tr. at 129, 140-41).

The Protestants also weighed in on the issue of rate case expense and cross-examined the Company's witnesses on this issue. In their post-hearing brief, Protestants argue three points that they developed from their cross-examination. First, the facts do not support the Company's claim that the outside consultants were retained because of the Commission's final order in the Company's last rate case. Second, the Company failed to quantify the fee paid to the outside consultants. In addition, the fee lacked credibility because it appeared that the cost of capital witness's testimony appeared to be a verbatim copy of testimony submitted by another employee of her firm in a proceeding before another state public utilities commission. Finally, Virginia ratepayers are entitled

to know who performed the work, what work was done on the rate case, how long it took, and what it cost. (Protestants' Post-Hearing Brief at 10-11).

The two questions that need to be answered to decide this issue are: (1) was it reasonable for the Company to retain outside consultants to prepare the rate case; and (2) were the rate case expenses incurred by the Company in this case reasonable.

In the Company's last rate case, the Company requested $110,686.88 in rate case expense. The Commission determined that $67,936 in rate case expense was reasonable, a difference of $42,750. In its final order, the Commission noted:

> Moreover, transactions which are not at arms' length [affiliate transactions] provide no incentive to limit costs. There is, instead, a tremendous incentive to incur more costs. (citation omitted). The incentive to incur more costs is especially true with regard to rate case expense. Additional time and resources spent for rate case preparation creates a situation where the affiliated company has no incentive to control its costs. The excessive time and resources spent in preparation of the case may benefit the affiliated company since it has an interest in the positive outcome of the proceeding. Yet, no additional expense is borne by the holding company in devoting the additional time and resources as would be the case if external unaffiliated attorneys, consultants and resources were used. Thus, the affiliated company is not limited by budgetary constraints by the client to control its costs or the competing interests of other clients.

1993 S.C.C. Ann. Rep. at 254.

Although the Commission's final order does not direct the use of outside consultants, it may certainly be read as discouraging the use of affiliated company personnel to prepare a rate case. The record in this proceeding establishes that the primary reason outside consultants were retained for this case was the Commission's final order in the Company's last rate case. (Ex. GSP-6, at 5-6; Tr. at 164). Unlike the Protestants, I cannot draw the inference from the record that the hiring of outside consultants was mere "happenstance." (Protestants' Post-hearing Brief at 10). The record indicates that AUS Consultants was approached to handle a number of small water company cases for UWMSC. AUS Consultants was asked to prepare a pricing structure to handle all of the cases. At that time, no case or company was discussed. (Tr. at 166). AUS Consultants was assigned the Virginia rate case at some later date. In response to a question from Protestants' counsel, the Company's accounting witness testified that he did not believe the Company's reason for hiring outside consultants was reached after-the-fact. (*Id*.). The Company was served with 335 interrogatories, with subparts, from the Staff and the Protestants in this case. I am surprised that no one asked the Company why they decided to hire outside consultants for this case. On this record, the Company witness's testimony stands unrefuted. Considering the admonition in the Commission's final order in the Company's last rate case, I find the Company's decision to retain outside consultants in this case was reasonable. In future rate cases, however, there should be a balance

between in-house personnel and outside consultants that produces the least cost rate case expense for the Company.

The next question is whether the Company reasonably incurred the requested rate case expenses. The Staff stated in its revised testimony that it wanted to place the burden of proving the reasonableness of the rate case expense on the Company. The concept of burden of proof involves two distinct legal requirements at a hearing. These requirements are generally referred to as the "burden of producing evidence" and the "burden of persuasion." The burden of producing evidence requires a party to produce sufficient evidence to avoid a directed verdict. The burden of persuasion requires a party to convince the trier of fact that a particular result should be reached in favor of that party. During a hearing, the burden of producing evidence may shift from one party to the other, but the burden of persuasion never shifts. In Commission rate cases, the party with the burden of persuasion must prove its case by a preponderance of the evidence. In other words, the Company has to prove that it is more likely than not, that its rate case expense is reasonable. *See generally*, C. Friend, The Law of Evidence in Virginia §§ 9-1 through 9-9 (1993).

In this case, the Company met its burden of producing evidence that its rate case expenses were reasonable. *See*, Ex. GSP-6. The burden of producing evidence then shifted to the Staff. The Staff, however, put on no direct evidence that the Company's rate case expenses were unreasonable. The Staff took the position that the burden of producing evidence was entirely on the Company. The Staff's accounting witness did address the Company's excessive rate case expense at the hearing; however, her testimony did not cover whether the rate case expenses incurred by the Company were reasonable. The concepts of excessive rate case expenses and reasonable rate case expenses are not always mutually exclusive, if one distinguishes between a rate case expense that is unusually large as opposed to one that is unreasonably large. As in this case, a company may have a large rate case expense that was reasonably incurred because of the time and expense involved in requesting a change in rates.

I find that the Company has met its burden with respect to establishing the reasonableness of its requested rate case expense. "In ordinary and customary usage, the word 'reasonable' means 'fair; just; ordinary or usual; not immoderate or excessive; not capricious or arbitrary.' It means what is 'just, fair and suitable under the circumstances'." *Sydnor Pump and Well Co. v. Taylor*, 201 Va. 311, 317-18 (1959). Applying these standards, I must agree with the Company that it is the time and expense involved in preparing and presenting a rate case that determines what level of expenses is appropriate, and the $111,255 requested by the Company appears reasonable under the circumstances of this case.

Throughout this proceeding, all of the parties have, at various times, lost sight of the fact that UWV is a small water company. As initially proposed, the Company's rate case expense may have been unreasonably excessive. However, as this case developed, what may have been unreasonable soon turned out to be inadequate. In this case, the Company had to respond to overly burdensome discovery and unnecessary litigation, which escalated the overall rate case expense. This included responding to 335 interrogatories, with subparts this totaled 519 questions; producing financial information that was not required of a Class C water company; incurring the expense of retaining a cost of capital witness; responding to the Staff's revised rate case expense testimony; responding to

the Protestants' attempt to re-litigate the Company's acquisition adjustment; and preparing to rebut testimony that was prefiled by the Protestants but never sponsored into evidence.

The record indicates that UWMSC personnel spent 650 hours responding to interrogatories, assisting the Staff with its on-site audit, and responding to follow-up questions. This total does not include any time spent preparing the Company's case for hearing. The Company's local manager spent 650 hours working on this rate case and her time is not even included in rate expense since her salary is already included in rate base. However, the time she devoted to this rate case was time away from her normal duties of running the day-to-day operations of the Company. The record indicates that the Company placed caps on the fees charged by the outside consultants and attorneys. The record further indicates that the fees for the outside consultants have already exceeded the cap and the fees for the outside attorneys were approaching their cap. At March 31, 1998, the Company had recorded $130,000 in rate case expense on their books. The Company's accounting witness's best estimate was that rate case expenses could approach $200,000 by the time this case is over. In retrospect, this makes the Company's decision to cap the fees for outside consultants and attorneys appear to be a sound business decision. (Exs. JLC-3; GSP-6, at 3-17; Tr. at 140-41).

I am not persuaded by the rate case expense arguments raised by the Protestants in their Post-hearing Brief. Protestants' argument regarding the hiring of AUS Consultants has already been addressed. The Protestants also argue that the Company's cost of capital witness testimony regarding her fee lacked credibility when confronted with the fact that her testimony was remarkably similar to that filed by her boss in a United Water Pennsylvania rate case. The record actually reflects that the Company's cost of capital witness is paid a salary and she did not know how much of her firm's $48,500 fee was attributable to her work. Her initial testimony was that she believed that it was $20,000 subject to check. (Tr. at 187). Later in her testimony, after a recess and apparently checking, she testified that she "was corrected, it's $8,500." (Tr. at 224). At least as far as I am concerned, a witness who responds to a question with an answer subject to check has the right later in their testimony to correct the answer for the record, without any stigma being attached to the response. With respect to Protestants' similar testimony argument, the record reflects that AUS Consultants has provided overall rate of return and cost of common equity testimony for 16 affiliates of UWV in the last four years. (Ex. PA-17). The record further reflects that AUS Consultants was retained to handle a number of small water company cases for UWMSC and to prepare a pricing structure to handle all of the cases. (Tr. at 166). To the extent that certain economies of scale are achieved in this process, the Company should be able to enjoy those economies. I reviewed the two sets of testimony and the duplication appears in the various economic theories supporting the use of certain methodologies for determining cost of capital. I would hope that basic economic theory does not change from case to case. Finally, Protestants argue that they should have the opportunity to know what the outside consultants and attorneys did in this case, how long it took, and what it cost. The Protestants had more than an adequate opportunity to discover this information. The time for discovery, however, is prior to the hearing not the day of the hearing. Since there were no motions to compel filed in this case, the Company apparently fully and completely responded to all discovery requests propounded by the Staff and the Protestants.

Insurance other than group

This issue involves the Company's general liability, workers' compensation, and small property liability insurance policies and whether the Company's rates should be based on a test year or a rate year level of expense.

The Staff argues that several of the Company's insurance policies experienced changes effective January 1, 1998. Consequently, the Staff included ten months of the revised costs and two months of the pro forma costs to calculate a rate year level of expense. (Ex. AJG-24, at 10).

The Company objects to the Staff's change in methodology from test year to rate year as being inconsistent. In the Company's application, insurance other than group expense reflected a test year level of expense, which also included annualized adjustments made to the test year level for known changes in operations occurring in 1997. (Ex. GSP-5, at 25-26).

I agree with the Company that, in this instance, the Company's proposed test year level of expenses should be used for ratemaking purposes. The Staff failed to explain the nature of the changes that occurred with the Company's insurance other than group expense and that these changes would continue into the future, which would support a change in methodology from test year to rate year. On this record, it is not clear which policies experienced a premium reduction and by how much. By way of example, most workers' compensation insurance policies are retrospectively experience rated. As a result, a company may have large swings in its workers' compensation insurance premiums from year to year based on their own experience. If this were the case, then it may be entirely appropriate to calculate insurance expenses based on a three-year average methodology rather than either a test year or rate year methodology.

Outside services-computer

The issue here is the level of information technology costs that should be borne by the ratepayers of a small water company. The Staff did not include in the cost of service an additional $14,560 requested by the Company to fund a system-wide integrated financial management system ("IFMS"). The Company's test year IFMS costs were $11,807, and the Staff believed this amount was more than adequate to meet the Company's information technology needs. The Staff's position was the Company failed to demonstrate how the system would benefit Virginia ratepayers. It appeared to the Staff that the system was primarily designed to benefit the Company's corporate parent. (Ex. AJG-24, at 11-12; Tr. at 240-41, 286-88).

The Company argues the new IFMS is necessary for the Company parent's transition from an antiquated mainframe system to a wide area network that would enable all of the parent's operating companies to communicate with each other and the corporate office. The IFMS includes general ledger, accounts payable/receivable, budgeting, time entry, payroll, human resources, project costing, asset management and procurement. According to the Company, some of the benefits of implementing the IFMS include standardization of desktop computers, creation of a common backbone communications network and consolidation of three mainframe data centers. The Company believes that implementing the system may free up local office employees to provide additional customer service. (Ex. GSP-4, at 21; GSP-5, at 6-8; Tr. at 339).

The Company has not met its burden of persuasion with respect to the additional expense requested for the IFMS. The system appears to be designed to improve the flow of information between the Company's corporate parent and its operating subsidiaries. If the corporate parent wants to improve communication technology with its operating subsidiaries, then let the corporate parent fund the improvements not the Virginia ratepayers of this small water company. Accordingly, I recommend that the Company should only be permitted to include the test year amount of $11,807 in computer costs in the Company's rates. This amount should be more than adequate to meet this small water company's information technology needs.

Internal audit

This is the other area where the Staff employed a rate year methodology rather than a test year methodology, which the Company opposes. UWR conducts an internal audit on all of its subsidiaries approximately every three years. The Company's last internal audit was conducted in April 1995, and the cost of that audit was amortized over the next three years.

The Staff argues that, based on discussions with the Company, the 1998 internal audit has not been scheduled as of the time their testimony was filed and may not occur until year-end. Due to the cost and the timing of the audit being uncertain, the Staff only recommended a rate year level of expense for internal audit costs. (Ex. AJG-24, at 15-16).

The Company argues that for a company the size of UWV it is not appropriate to mix various methodologies when developing a pro forma level of expenses. The Company's accounting witness testified that the Company anticipates performing the audit by the end of 1998. (Ex. GSP-5, at 27).

Since it appears from the testimony of the Company's witness that the audit is to be performed by the end of 1998, I agree with the Company that the cost of that audit should be included when developing a pro forma level of expenses.

Uncollectibles

The Summary Statement of adjustments attached to the Company's post-hearing brief indicates that this issue is still in dispute; however, the Company's accounting witness testified that the Company agrees with the Staff on this issue. (Tr. at 129). Therefore, I find the Staff's adjustment to be reasonable.

Gross receipts taxes

Gross receipts taxes are affected by the Company's revenue requirement. Naturally, the Staff's and the Company's differing revenue requirements have produced different totals for gross receipts taxes. While there has not been an agreement between the parties on this issue, it appears that gross receipts taxes are just a flow-through of total revenues. (Tr. at 130). Therefore, gross receipts taxes should be calculated based on the revenue requirement recommended herein.

Parent company debt adjustment

The Staff and the Company disagree whether an adjustment should be made to recover part of the tax deduction on the interest on the debt of UWR, the Company's grandparent.[2] The Staff argues that the Company's parent UWW and its grandparent UWR receive tax benefits in the form of interest deductions that they take on their consolidated tax returns as a result of using debt to purchase the equity of their subsidiaries. The Staff further argues that Virginia ratepayers are paying a return on equity allowance built into customers' rates that flows through dividend payments from the Company to UWW and ultimately to UWR. Finally, the Staff argues that Virginia ratepayers should share in the resulting tax benefit enjoyed by UWR. (Ex. AJG-24, at 20-21; Tr. at 243).

The Company argues that the Staff's adjustment is inconsistent with the fact that the Company's sole source of external capital is UWW. The Company further argues that the case relied on by the Staff, *Application of Virginia-American Water Company*, Case No. PUE950003, 1997 S.C.C. Ann. Rep. at ___, is analogous to the financing being made at the UWW level in this case. The Company argues UWW's interest expense was used for the purpose of computing federal income taxes for the Company. (Ex. GSP-5, at 31-32; Tr. at 131).

It probably is more precise to call this issue the "grandparent" company debt adjustment. This is a case of first impression for the Commission. In the two cases relied on by the Staff in its post-hearing brief, *Application of Virginia-American Water Company*, Case No. PUE950003, and *Application of GTE South Incorporated*, Case No. PUC950019, 1997 S.C.C. Ann. Rep. at ___, the Commission addressed the appropriateness of a "parent" company debt adjustment. In those cases, the immediate parents benefited from accrued tax benefits supported by Virginia ratepayers. The tax benefits were derived from the parents' use of debt to invest in the equity of their operating subsidiaries. The Staff is applying the logic of those two cases to bypass the parent, UWW, in this case and reach the grandparent, UWR.

Based on the record in this proceeding, I agree with the Company that the Staff's grandparent company debt adjustment should be rejected. I believe there must be a nexus between the Virginia ratepayers, the debt that is used to purchase equity in an operating subsidiary, and the tax benefit that is derived from the interest deduction on that debt. I find that nexus lacking in this case. The record in this proceeding indicates that the debt in question was not consolidated debt and was issued by UWR primarily to fund its overseas non-regulated operations. (Ex. AJG-29; Tr. at 293-94). The record further indicates that UWR has not used its debt financing to infuse any equity into UWW, nor does it currently have any plans to do so. (Tr. at 197). Under the facts of this case, I find that the nexus between the Virginia ratepayers and the debt issued by UWR is too remote to support a grandparent company debt adjustment.

Deferred federal income taxes

The Staff and the Company disagree on the amount of the Company's deferred federal income tax expense. The Staff argues that it used the Company's response to an on-site audit request to calculate deferred federal income tax for the book/tax timing difference for depreciation expense. The Staff argues that the audit request shows that only a portion of the normalized book/tax

[2] *See*, UWR organizational chart attached to this Report as Attachment B.

difference is deferred. The Staff further argues that, since taxes are normalized, the rest of the excess book/tax difference for depreciation flows through current federal income tax expense. (Tr. at 243-44).

The Company argues that it had to correct the Staff's calculation of deferred federal income tax since the Staff incorrectly reflected the level of excess tax depreciation over book. The Company further argues that the Staff has understated deferred federal income tax by $6,815. They argue the correct total deferred income tax expense should be $47,879. (Ex. GSP-5, at 30-31). The Company's explanation of the difference in the deferred federal income tax expense appears reasonable. Therefore, I find that the total deferred income tax expense should be $47,879.

Rate base

This issue has two subparts: utility plant in service and accumulated depreciation reserve.[3] The difference between the parties in the utility plant in service involves $1,500 of deferred tank painting costs associated with the installation of OSHA-required handrails that the Staff removed from the Company's deferred tank painting expense. (Tr. at 242). I agree with the Staff that the cost of the handrails should be removed from the Company's deferred tank painting expense and should be capitalized. Since the Company incurred the cost of the handrails within 12 months of the end of the test year, I agree with the Company that the pro forma utility plant in service should be adjusted accordingly. Therefore, I find that the Company's utility plant in service should be $3,500,936 in this proceeding.

The accumulated depreciation reserve issue involves an adjustment the Staff made to annualize accumulated depreciation. The Staff believes that accumulated depreciation and depreciation expense are inherently linked. The Staff further believes that if one is given an annual effect, then the other one should be adjusted to reach the same effect. The Staff's adjustment to accumulated depreciation was designed to update it to include the same level as Staff's adjustment to depreciation expense. (Tr. at 242). The Company does not agree with the adjustment and suggests it be disregarded in determining final rates. It appears from the record that the Commission has accepted the Staff's accumulated depreciation methodology in previous rate cases. (Tr. at 242). Therefore, I find that the Staff's use of this methodology in this proceeding was proper.

II. Cost of Capital Issues

The Company proposed an overall cost of capital of 9.99% based on the consolidated capital structure of United Waterworks ("UWW") (UWV's immediate parent) as of December 31, 1996. The capital structure consisted of 52.50% long-term debt, 0.15% preferred stock, and 47.35% common equity. The Company also proposed a return on equity of 11.90%. (Tr. at 184).

The Staff calculated a range of 8.875% to 9.390% for the Company's total cost of capital. The Staff based its total cost of capital range on UWW's updated capital structure as of December 31, 1997. At this time, UWW's capital structure consisted of 47.761% long-term debt, 0.118% preferred stock, 1.328% investment tax credits, and 50.793% common stock. The Staff

[3] The Company's OPEB costs were not allowed; therefore, they should not be included as part of rate base.

recommended a cost of equity range of 9.60% to 10.60%, with rates set at the 10.10% midpoint of the range. (Tr. at 300-01).

Capital Structure

In their post-hearing brief, the Protestants objected to the use of UWW's capital structure for establishing rates in this case. The Protestants argue the consolidated capital structure of United Water Resources, Inc. ("UWR") (UWV's ultimate parent) should be used for ratemaking purposes. The Protestants further argue UWR has created multiple levels within its corporate structure for the purpose of skewing the capital structure used in ratemaking proceedings. (Protestants' Post-Hearing Brief at 3).

In its brief, the Company argues that the cost of capital witnesses of both the Company and the Staff recommended using UWW's capital structure, not UWR's. The Company advances three reasons for using UWW's capital structure. First, it is comparable to the typical capital structure of companies in the water utility industry. Second, it properly recognizes UWV's source of financing for rate base assets. Finally, it was the capital structure used by the Commission in the Company's 1992 rate case. (Applicant's Post-Hearing Brief at 15).

The Company's cost of capital witness testified a utility's rates should be cost-based and company-specific. She testified that if a utility issues its own equity and debt, the utility's own capital structure should be used. However, when a utility receives all of its working capital from its parent, the parent's consolidated capital structure should be used for rate of return purposes. She testified that the per books capital structure of UWV consists of 100% common equity, which is owned by its parent UWW. She further testified that UWW supplies all of the external working capital for UWV and all of its other operating subsidiaries. In her opinion, it is entirely appropriate to use UWW's capital structure for determining the overall cost of capital for UWV. (Ex. PA-16, at 19).

The Staff's cost of capital witness testified that the Commission used UWW's capital structure in previous rate cases. She testified that the Company receives all of its financing from UWW, and the Company's capital structure is subject to UWW's management discretion rather than being influenced by the capital markets. She testified that in its cost of capital analysis the Staff generally uses a capital structure that is affected by the capital markets. Since UWW issues its own debt, she found it appropriate to use UWW's capital structure. She further testified that she updated UWW's capital structure as of December 31, 1997, to reflect the Company's prospective long-term capitalization ratios. She reviewed UWW's capital structure for the test year, December 31, 1996, and from January 1, 1997 through September 31, 1997, and found no large issuance of debt or equity. However, in the fourth quarter of 1997, UWW issued two long-term notes totaling over $17,000,000. She included these long-term notes in her capital structure to more accurately reflect UWW's capital structure on a going-forward basis. (Ex. MEO-30, at 5-7).

The case relied upon by the Protestants in their brief is particularly instructive on this issue. *Bell Atlantic v. Pub. Serv. Comm'n of D.C.*, 655 A.2d 1231 (D.C. App. 1995). In this case, Bell Atlantic-Washington, D.C. ("BA-DC") appealed a decision of the Public Service Commission of the District of Columbia ("PSCDC") that found BA-DC failed to meet its burden of proving that its

parent Bell Atlantic Corporation ("Bell Atlantic") did not control or manipulate BA-DC's capital structure.

In a previous rate case, PSCDC found actual manipulation of BA-DC's capital structure by Bell Atlantic. The evidence showed that Bell Atlantic set debt ratio ranges for BA-DC to follow; that BA-DC's divided payout ratios were manipulated in order to increase BA-DC's equity ratio for ratemaking purposes; that BA-DC's equity ratio was significantly higher than Bell Atlantic's while BA-DC's lower business risk should have produced a lower equity ratio; and that Bell Atlantic could not operate its non-regulated subsidiaries with the amount of equity remaining on its balance sheet after subtracting the equity from its regulated subsidiaries. The evidence also included a letter from the President and CEO of BA-DC to Bell Atlantic asking for permission to defer BA-DC's third quarter dividend payment in order to affect BA-DC's debt ratio for an upcoming rate hearing. Despite PSCDC's preference for using BA-DC's capital structure, PSCDC used Bell Atlantic's capital structure for ratemaking purposes. In its final order, PSCDC put BA-DC on notice that, in any future rate hearings, it would have to prove Bell Atlantic did not control or manipulate BA-DC's capital structure. (*Id*. at 1234).

The Court found that, in any future rate case before PSCDC, BA-DC must show that "it can and has set a debt ratio which is wholly appropriate to its role as a regulated provider of telephone services, and has in no sense been influenced by its relationship to Bell Atlantic in doing so." (*Id*. at 1235). The Court did not address the question of whether the ability to manipulate a subsidiary's capital structure, without actual evidence of such conduct, would be sufficient to impute the parent's capital structure to the subsidiary for ratemaking purposes. (*Id*. at n. 5).

In contrast to the *Bell Atlantic* case, there is no evidence in this record of actual manipulation of the capital structure of UWW by UWR. Counsel for Protestants takes issue with the fact that Schedules 6 and 7 of Ms. Ahern's prefiled testimony show UWW had $222,738,313 in long-term debt as of December 31, 1996, and UWR's 1996 Annual Report to stockholders shows UWW had $246,630,000 in long-term debt as of December 31, 1996. However, it was not established that either of these numbers was incorrect for the purpose for which it was used. On cross-examination, Ms. Ahern testified that she was provided with the long-term debt number used in her testimony by UWMSC and she had no reason to believe that the number was incorrect. (Tr. at 218-21). On cross-examination, the Staff's witness testified that she was aware of the discrepancy, but that it was not relevant to her analysis since she was updating UWW's capital structure to December 31, 1997. (Tr. at 304-05).

In the absence of evidence of actual manipulation, the question faced by the Commission is whether the capital structure of UWR should be imputed to the Company solely on the basis of UWR's ability to manipulate UWW's capital structure. There are compelling reasons why this should not be done. UWR is a diversified holding company. It has as one of its subsidiaries a company that is engaged in the business of real estate management. Unlike UWW's capital structure, UWR's capital structure may not be comparable to a company whose only business is operating water utilities. (S*ee*, Ex. MEO-30, Schedule 1). In this case, the capital structure recommended by the Staff more accurately reflects the current trend in the water utility industry, where, over the last five years, the percentage of long-term debt held by companies is decreasing and the percentage of

common equity is increasing. (*See*, Ex. PA-16, Schedule 6, pg. 2 of 3). In addition, the Staff's recommendation represents UWW's capital structure on a going- forward basis and is more reflective of the industry's long-term trend in capitalization ratios.

The Delaware case cited by the Protestants in their brief is not persuasive authority in this case and may be distinguished on the facts. *United Water v. Pub. Serv. Comm'n of Delaware*, 1998 WL 283497 (Del. Super. Ct.). In the Delaware case, the record reflected that UWR would provide the ongoing capital for UWW and its subsidiary United Water Delaware ("UWD"). (*Id*. at 5). This appeared to be the primary factor relied on by the judge in reaching his decision. He ultimately found that the Delaware Public Service Commission's decision to use UWR's capital structure to establish rates for UWD was supported by substantial evidence in the record and resulted in fair and reasonable rates.

The record in this case reflects that the Company will obtain its external equity financing from UWW. UWW may not necessarily obtain its external equity from UWR. Since the merger of UWR and General Waterworks in 1994, UWR has not infused any equity into UWW, nor does it currently have any plans to do so. (Tr. at 197). UWR may have the ability to influence the capital structure of UWW, but the investing public also influences the capital structure of UWW. UWW issues its own debt to the public and has its own bond rating. (Tr. at 210-11). The evidence in this case is far from conclusive that the Company receives, or will receive, any of its equity or debt financing from UWR. Therefore, I find that the use of UWW's capital structure, updated to December 31, 1997, as recommended by the Staff, to be reasonable for purposes of establishing rates for UWV. I further find that the Staff's recommendation with respect to including investment tax credits and reflecting long-term debt balances net of unamortized debt issuance expenses in the capital structure to be reasonable. The Staff's recommended capital structure more accurately reflects UWW's capital structure on a going-forward basis. The Commission should, however, direct the Staff to review UWW's capital structure on an annual basis to determine whether the Commission should continue using UWW's capital structure for ratemaking purposes. If the Staff uncovers any evidence that UWR is providing external capital to UWW or manipulating UWW's capital structure, the Staff may request a hearing before the Commission to present such evidence.

Cost of Equity

The Company's cost of capital witness recommended a return on common equity of 11.90%. She arrived at her recommendation by applying three different cost of common equity models, the Discounted Cash Flow ("DCF"), Risk Premium ("RP") and Capital Asset Pricing Model ("CAPM"), to two proxy groups. The first proxy group consisted of five Eastern water companies. These included Aquarion Co.; Connecticut Water Service, Inc.; E'Town Corp.; Middlesex Water Co.; and Philadelphia Suburban Corp. The second proxy group consisted of six companies published in Value Line Investment Survey. These companies included American Water Works Co., Inc.; Aquarion Co.; California Water Service Co.; Consumers Water Co.; Philadelphia Suburban Corp., and United Water Resources, Inc. (Ex. PA-16, at 4-7, and Schedules 4 and 5).

The results of Ms. Ahern's analyses are as follows:

	DCF	RP	CAPM
Proxy Group of Five Eastern Water Companies	10.6%	12.4%	11.7%
Proxy Group of Six Value Line Water Companies	9.6%	12.0%	11.2%

After she applied the three cost of common equity models, the resulting cost of common equity was 11.90% for the group of five Eastern water companies and 11.5% for the Value Line water companies. Ms. Ahern's recommendation was based on the indicated 11.90% cost of common equity for the group of five Eastern water companies. She believes these companies are more similar to UWV and UWW in terms of size and geographic location, than the Value Line water companies. (Ex. PA-16, at 7).

Ms. Ahern used interest coverage and comparable earnings analyses as checks on the reasonableness of her recommended 11.90% cost of common equity. Her interest coverage analysis used a cost of capital of 9.99%, a cost of equity of 11.90%, and a 47.35% equity ratio. The result of the analysis showed that UWV has the opportunity to cover interest charges 2.6 times before income taxes. The result appeared reasonable to Ms. Ahern, in light of Standard & Poor's requirement that water utilities with business positions of "low average" and "somewhat below average" cover interest charges 2.25 and 2.50 times. (Ex. PA-16, at 46). In her comparable earnings analysis, Ms. Ahern chose a proxy group of domestic, non-price regulated companies to reflect the systematic (market) and unsystematic (business and financial) risks of the proxy group of five Eastern water companies. Ms. Ahern used the beta for these companies to measure systematic risk and the residual standard error to measure unsystematic risk for each of these companies. The result of Ms. Ahern's comparable earnings analysis was 14.6%, which she considered to be conservative. Ms. Ahern compared the 14.6% result of her comparable earnings analysis to her recommended 11.90% cost of common equity and found her 11.90% cost of common equity to be reasonable, if not conservative. (Ex. PA-16, at 47-50).

The Staff's cost of capital witness recommended the use of a cost of equity range of 9.60% to 10.60% with rates set at the midpoint 10.10%. To arrive at her recommended cost of equity range, Ms. Owens used the DCF analysis for UWR and a group of five water companies. Her proxy group included American Water Works, Aquarion Co., California Water, Consumer's Water, and Philadelphia Suburban. In addition, Ms. Owens relied on two risk premium models, the CAPM and an Ex Ante Risk Premium methodology. (Ex. MEO-30, at 13; Tr. at 300).

The results of Ms. Owens' analyses are as follows:

	DCF	CAPM	EX ANTE[4]

[4] The Staff's Ex Ante Risk Premium analysis covers the period 1980 through 1993, and applies to current interest rates affecting both UWR and the proxy group of five water companies.

United Water Resources		10.10%	10.58%
Range	8.74%-9.46%		
Midpoint	9.10%		
Proxy Group of Five Water Companies		10.40%	10.58%
Range	8.91%-9.36%		
Midpoint	9.14%		

Based on the foregoing, Ms. Owens recommended a cost of equity range of 9.60% to 10.60% with rates set at the 10.10% midpoint of the range. (Ex. MEO-30, Schedule 14).

I find the Staff's recommended return on equity range of 9.6% to 10.6% with rates set at the 10.10% midpoint of the range to be reasonable. It appears from the record herein that the Staff's use of updated market data in its cost of equity analysis more accurately reflects current market conditions affecting UWV.

III. Tariff and Rate Design Issues

The most controversial tariff and rate design issue is the reduction of the bimonthly minimum allocation from 6,000 to 5,000 gallons. The Company proposed the reduction to address concerns by seasonal customers apparently raised in the Company's last rate hearing. The Company's analysis of test year bills indicates that 52% of the Company's customers consumed 5,000 gallons or less bimonthly. Based on the Company's proposed rates, a person using the minimum allowance would see a 10.08% increase in their rates, a person using the old allowance of 6,000 gallons would see a 17.12% increase in their rates, and the average customer who uses 7,000 gallons bimonthly would see an 18.14% increase in their rates. The Company's overall requested increase is 16.06%. (Ex. GSP-4, at 22-23; Tr. at 131).

The Staff supports the Company's proposed reduction in minimum usage. The Staff views the reduction as a means of addressing the needs of seasonal and low usage customers by working towards a cost-based rate. In the Staff's opinion, reducing the minimum usage will not affect a majority of the Company's customers. (Ex. JAS-32, at 5).

In this proceeding, there has been no groundswell of support from seasonal or low usage customers for the Company's proposed reduction in minimum usage. The primary concern of the Company's customers appears to be the magnitude of the Company's proposed rate increase coupled with a decrease in the minimum usage. The Intervenors view the Company's proposal as nothing more than a means of increasing revenue for the Company. (Ex. JAS-32, at 3; Tr. at 45-46).

In order to understand the genesis of this issue one must go back to the Commission's Final Order in Case No. PUE890082. In that case, the Commission found that the Company should collect cost information data and analyze the data to determine whether an additional rate block providing for lower minimum gallon usage would address the needs of the Company's seasonal and limited usage water customers. The Company was directed to submit the data and its analysis to the

Commission's Division of Energy Regulation prior to the Company's next rate hearing. 1991 S.C.C. Ann. Rep. 267, 269.

In the Company's 1992 rate case, Case No. PUE920015, the Company submitted an alternative rate design as part of its rate case. The proposed rate design provided for a minimum charge with no usage included and a two-tiered volumetric rate block. The Staff opposed the Company's alternative rate design for two reasons. First, the average customer who used 7,000 gallons of water bimonthly would have seen a 60.57% increase in their water bill. Secondly, the Staff believed the Company's alternative design ignored a majority of the Company's customers who were full-time residents. In lieu of the Company's alternative rate design, the Staff proposed two additional rate designs. The Staff could not recommend adoption of either of its proposals because of the impact they had on customers' rates. Even under the Staff's proposal, the average customer's bill would have increased by 46.86% above the Company's proposed 35.5% increase. The Staff ultimately recommended that, if the Commission approved a revenue requirement less than what was requested by the Company, the reduction should be applied to the Company's proposed minimum charge. The Hearing Examiner agreed with the Staff. Report of Howard P. Anderson. Jr., Hearing Examiner, at 17-18 (October 19, 1992). In its Final Order, the Commission adopted the Hearing Examiner's findings and recommendations on this issue. 1993 S.C.C. Ann. Rep. 252, 253.

I find that there is little or no evidence in this record to recommend a reduction in the bimonthly minimum allocation from 6,000 to 5,000 gallons. The Company has approximately 151 seasonal customers, who account for 8% of its customer base. (Ex. JAS-32, at 4). This raises the question: should the Company reduce the minimum usage for 100% of its customers to satisfy the supposed concerns of 8% of its customers? There is no evidence in the record to indicate that the Company's seasonal or low usage customers are in favor of, or even requested a reduction in the bimonthly minimum usage. They may have raised the issue in the Company's 1989 rate case as an alternative to any rate increase, which the Commission addressed in the Company's 1992 rate case, but they certainly did not raise the issue in this case. Perhaps in the future, the Company should survey its customers to determine their needs and place those survey results into the record to substantiate the Company's claim that it is undertaking a course of action on their behalf. In this case, if the Commission finds that a reduced revenue requirement is appropriate, the concerns of all of the Company's customers should be satisfied if the reduction is applied to the minimum charge.

The second most controversial issue was the Staff's recommendation to add a third rate block for usage above 15,000 gallons. The Staff recommended the addition of this rate block to discourage wasteful usage. A billing analysis provided by the Company indicated that approximately 4% of the Company's customers consumed 15,000 gallons or more. These customers represented 20% of the Company's total water consumption. The highest water user consumed 1,051,000 gallons during a bimonthly period. (Ex. JAS-32, at 5).

The Company countered that the addition of the 15,000 gallon inverted rate block would cause revenue volatility and would increase the likelihood that the Company would not recover its authorized level of revenues. Mr. Prettyman testified that when customers are faced with a higher incremental rate block they would find ways to conserve water and lower their overall bill. (Ex. GSP-5, at 33; Tr. at 131).

The Company's position on this issue seems a little disingenuous. Ms. Creel testified on cross-examination that she has an obligation to future generations to ensure that water is protected and conserved. (Tr. at 100). However, the Company is opposed to a proposal to discourage wasteful water consumption. Mr. Prettyman testified that the addition of an inverted rate block would cause rate volatility. (Tr. at 131). However, he ignores the fact that the Company has proposed an incremental rate block for usage above the minimum allocation that is just as likely to cause rate volatility, if one accepts his argument that higher rates cause water conservation and a corresponding decrease in Company revenues.

I find that the Staff's proposal to include a third inverted rate block for usage above 15,000 gallons is reasonably calculated to discourage wasteful water consumption. Only time will tell whether the addition of this rate block will have an impact on water consumption and a corresponding impact on revenues. Some of the Company's customers who use over 15,000 gallons may decide to conserve water and some of the customers may decide to just pay the higher rate, in which case there would be a revenue offset. At the present time, it is just as likely to cause an increase in revenues, as it is to cause a decrease in revenues. Using the Company's proposed rate, for every 1,000 gallons of water that are conserved above 15,000 gallons, the Company would lose $4.32 in revenues. Using the Staff's proposed rate, for every 1,000 gallons consumed above 15,000 gallons, the Company would generate $6.00 in revenues, a net increase in revenues of $1.68 per 1,000 gallons.

The Staff also recommended that seasonal customers be charged a "seasonal charge" of $10.00 per month for months they are disconnected from the system. The Staff proposed this charge to allow for a more equitable distribution of the ongoing fixed costs of operating a water system between seasonal and full-time customers. The Staff compares this charge to an availability fee since the water system is maintained throughout the year and water is available to seasonal customers upon request. The Staff found that the average seasonal customer disconnects from the system for an average of 4.7 months. (Ex. JAS-32, at 4-5).

The Company does not oppose the addition of a seasonal charge in its rate design. (Ex. GSP-5, at 32-33). However, one of the Intervenors testified that seasonal customers are being penalized with excessive minimum charges when they are not using any water. (Tr. at 46).

The Company should be able to recover a reasonable fee from seasonal customers to support the full-time operation and maintenance of its water system. Although seasonal customers connect to the system, pay for the water they consume, and then disconnect from the system, the Company is still required to construct and maintain a water system that is capable of meeting the system's peak demand. This demand occurs when seasonal customers are connected to the system. When a seasonal customer disconnects from the system, the Company is left with excess capacity and no corresponding revenue stream to support that capacity. If the Commission approved the seasonal charge, the average seasonal customer would pay a total annual charge of $50.00. For comparison, one of the Intervenors testified that the electric cooperative that serves their area charges $8.50 per month for no usage if service remains connected. (Tr. at 47). The proposed $10.00 per month

seasonal charge appears to be reasonable in relation to the demand placed on the Company's water system by seasonal customers and should be approved by the Commission.

The Company has also requested an $80.00 reconnection charge for connections that are made after-hours, on weekends, or on holidays. The charge is based on the number of occurrences, travel time, overhead rate and overtime salary. (Ex. GSP-4, at 23). The Company supplied the Staff with a worksheet on its meter reconnection expense for the test year. Since the weighted average cost for after-hours reconnections was approximately $80.00, the Staff had no objection to the charge. (Ex. JAS-32, at 7-8). One of the Intervenors, a seasonal customer, questioned the reasonableness of the Company's charge. (Tr. at 46-47).

It appears that the $80.00 after-hours reconnection charge is designed to address the situation where someone failed to pay their water bill, service has been disconnected, and the person wants service restored as soon as possible. The Company's proposed tariff requires that all outstanding balances be paid before service will be restored. Seasonal customers can simply avoid this charge by having service reconnected during normal working hours. A review of the Company's tariff on file with the Commission indicates that the Company charges $40.00 for a reconnection during normal working hours and it does not have a disconnect charge.

The Staff has also recommended that the Company's tariff be amended to reflect that the Company's service connection charge is $550.00 and that language providing for a gross-up of applicable taxes, if any, be included as part of the charge. The Company currently charges $610.00 for a service connection, $550.00 for the actual cost of the service connection and $60.00 for federal income tax. (Ex. JAS-32, at 8-9; Tr. at 312). On cross-examination, Mr. Stevens testified that the Staff was recommending this change to allow for a refund to the Company's customers if it was later determined that the customer should not have paid federal income tax on the service connection fee. (Tr. at 325-26).

Ms. Gilmour, the Staff's accounting witness, testified that § 118 of the Internal Revenue Code was amended on June 12, 1996, for water and sewer utilities. Specifically, the definition of contribution in aid of construction ("CIAC") was amended to read CIAC "shall be defined by regulations prescribed by the Secretary [of the Treasury], except that such term shall not include amounts paid as service charges for starting or stopping services." 26 U.S.C. § 118(c)(3). Apparently, the amendment created confusion whether connection fees are considered CIAC and whether they are subject to federal income tax. The Secretary of the Treasury has not issued any regulations further defining CIAC. Ms. Gilmour's testimony offers an alternative to the recommendation of her colleague, Mr. Stevens. She recommended that the Company should cease collecting the income tax gross-up until such time as it obtains a ruling from the Internal Revenue Service. If the Company is taxed on the connection charge, then the Company should bring the matter before the Commission. (Ex. AJG-24, at 22; Tr. at 232).

The Company's position is that the language in the tariff should remain the same. They believe this change is unnecessary, and that adding tax to the connection charge would confuse customers. (Ex. GSP-5, at 34; Tr. at 131).

I agree with the Staff that the language regarding connection fees should be changed in the Company's tariff to reflect the actual cost of the connection fee, plus any applicable taxes. I am not persuaded by the Company's argument that somehow changing the language will confuse the Company's customers. Consumers make millions of purchases every day without knowing what their sales tax liability will be. The consumer is more concerned with the actual cost of the goods or services than they are with the tax consequences of that purchase. It is almost a given that any purchase of goods and services involves the payment of some tax. I find the approach advocated by Staff witness Stevens to be a reasonable way to resolve this issue. The Company should be permitted to continue collecting the tax gross-up on connection fees subject to refund, if it is later determined that the Company should not have collected the tax. The Commission should require the Company to submit a request to the Internal Revenue Service for a Revenue Ruling on the applicability of 26 U.S.C. § 118 to connection fees for water and sewer companies. The request for the Revenue Ruling could be prepared by UWMSC on behalf of the Company. The preparation of this type of request certainly falls within the scope of UWMSC's general duties under the management and service contract with the Company.

The Company may have erroneously collected the tax from a number of its customers since the Internal Revenue Code was amended in 1996. The Commission should also direct the Company to make refunds to these customers, if it is determined that taxes should not have been paid on service connection fees. It appears that the Company may have to make refunds to less than 30 of its customers. (Exs. GSP-9 and 10).

The Staff also recommended additional changes to the Company's tariff for purposes of clarification. These included: delete Rule No. 10(B) regarding landlord/tenant responsibility for water bills; delete "or his agent" from Rule No. 16(E); modify Rule No. 8 to allow 10 days' written notice before service is disconnected for specified reasons; and modify Rule No. 11 to state that water bills are due within 30 days of the billing date and that, after such time, the Company can disconnect service after 10 days' written notice. The Company had no objection to incorporating these changes in its tariff. (Ex. GSP-5, at 32-33; Tr. at 131). I agree with the Staff's recommended changes to the Company's tariff. If these changes are adopted, the Company's and the customer's rights and responsibilities under the tariff will be clearly set forth.

IV. Protestants' Issues

The final issue the Protestants raised in their brief that has not already been addressed is the Company and Staff's calculation of working capital. The Protestants argue that both the Company and the Staff accounting witnesses have adopted a policy of computing total working capital that supercedes the Commission's Rules Implementing Small Water or Sewer Public Utility Act (the "Rules"). The Protestants argue the Commission's Rules provide that total working capital consists of two components: cash, and materials and supplies. The Protestants argue that the Company had the choice of a cash study plus materials and supplies, or it could follow § 3 of the Rules and use $1/9^{th}$ of the O&M expenses as the total allowance for working capital. Apparently, the Company and Staff accounting witnesses used $1/9^{th}$ of O&M expense to calculate cash working capital. Then they calculated a 13-month average for materials and supplies and added this sum to cash working capital to arrive at total working capital.

On initial review, Section 3 of the Rules and the exhibit Rate of Return Statement appear to be inconsistent. Section 3 indicates that "working capital" is computed as 1/9th of a company's O&M expense, while the exhibit indicates that "total working capital" is the sum of cash working capital and materials and supplies. It appears the drafters of the Rules intended that Section 3 apply to "cash" working capital. The Commission has historically interpreted Section 3 in this manner. *See, e.g., State Corporation Commission v. Thomas Bridge Water Corporation*, Case No. PUE940010, 1995 S.C.C. Ann. Rep. 295 and *Bruce M. Berry, et al. v. Virginia Suburban Water Company*, Case No. PUE920015, 1993 S.C.C. Ann. Rep. 252. Generally, total working capital is the sum of cash working capital and materials and supplies. Cash working capital may be computed by using the 1/9th methodology or by preparing a lead-lag study. The 1/9th methodology is used as a reasonable estimate of what a lead-lag study would produce without the time and expense of conducting a study. *See,* R. Hahne & G. Aliff, Accounting for Public Utilities §§ 5.01 through 5.04 (1996). Since the Rules apply to small water companies, it appears that the drafters intended the 1/9th methodology to be a low cost alternative to a lead-lag study for these companies to compute cash working capital. It appears that the Commission's application of its Rules comports with generally accepted public utility accounting conventions, and permits Section 3 and the exhibit Rate of Return Statement to be read in harmony. Considering the foregoing, I find the Company and the Staff's calculation of total working capital to be reasonable.

Findings and Recommendations

Based on the evidence received in this case, and for the reasons set forth above, I find that:

(1) The use of a test year ending December 30, 1996, was reasonable;

(2) The rates proposed by the Company are excessive. In lieu thereof, the Commission should direct the Company to set rates to produce revenues of $96,497.00;

(3) The Company's customer growth was 22 as of September 30, 1997, and its average water use per customer during the test year was 38.33 thousand gallons;

(4) A three-year average, without adjustment, should be used to calculate the Company's overtime and summer help expense, and all payroll expense accrued in the test year should be included in the Company's 1996 per books payroll expense;

(5) The Commission should disallow the cost of the Virginia-specific actuarial study in the Company's rates;

(6) The Commission should accept the Staff's position with respect to SFAS 106 costs;

(7) The Company's requested rate case expense of $111,155 appears reasonable under the circumstances of this case;

(8) The Commission should accept the Company's proposed insurance other than group expense;

(9) The Commission should reject the Company's proposed $14,560 increase in IFMS expense and should accept the test year expense of $11,807;

(10) The Company's proposed internal audit expense should be accepted;

(11) The Staff's proposed parent company debt adjustment should be rejected;

(12) The Company's deferred federal income tax expense for this proceeding should be $47,879;

(13) The Company's utility plant in service for this proceeding should be $3,500,936;

(14) The Staff's adjustment to accumulated depreciation appears reasonable;

(15) The use of UWW's capital structure, updated to December 31, 1997, as recommended by the Staff, appears reasonable;

(16) The Staff's recommended return on equity range of 9.60% to 10.60% with rates set at the 10.10% midpoint of the range appears reasonable; and

(17) The tariff and rate design modifications recommended herein should be adopted by the Commission.

I therefore ***RECOMMEND*** that the Commission enter an order that:

(1) ***ADOPTS*** the findings contained in this Report;

(2) ***GRANTS*** the Company an increase in gross annual revenues of $96,497.00;

(3) ***DIRECTS*** the prompt refund of amounts collected under interim rates in excess of the rate increase found reasonable herein; and

(4) ***DISMISSES*** this case from the Commission's docket of active cases and passes the papers herein to the file for ended causes.

Comments

The parties are advised that any comments (Section 12.1-31 of the Code of Virginia and Commission Rule 5:16(e)) to this Report must be filed with the Clerk of the Commission in writing, in an original and fifteen (15) copies, within fifteen (15) days from the date hereof. The mailing address to which any such filing must be sent is Document Control Center, P.O. Box 2118,

Richmond, Virginia 23218. Any party filing such comments shall attach a certificate to the foot of such document certifying that copies have been mailed or delivered to all other counsel of record and any party not represented by counsel.

Respectfully submitted,

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Michael D. Thomas
Hearing Examiner